In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 1410

MIDWESTERN GAS TRANSMISSION COMPANY, EAST TENNESSEE NATURAL GAS COMPANY, PETITIONERS

v.

FEDERAL POWER COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

Until recently the Federal Power Commission permitted a regulated utility using liberalized depreciation for tax purposes to "normalize" for rate making purposes: *i.e.*, to include in its cost of service an allowance for taxes computed on the basis of straight line depreciation, with the difference between the higher amount allowed and the tax actually paid being set aside in a so-called "deferred tax" reserve. Then, in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, affirmed, 359 F. 2d 318 (C.A. 5), certiorari denied, 385 U.S. 847, the Commission concluded that where, as in that case, the company had an expanding plant—*i.e.*, the cost of replacements and additions exceeds the cost of retirements—liberalized depreciation results in an actual saving, rather than a mere deferral of taxes. The Commission consequently ordered

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tion results in an actual saving, rather than a mere deferral[1] of taxes. The Commission consequently required that such savings be "flowed through" to the ratepayers.

Up to the decision in *Alabama-Tennessee*, petitioners had been using liberalized depreciation for tax purposes (Pet. 7).[2] Thereafter, during the course of investigations into their rates under Section 5(a) of the Natural Gas Act, each petitioner changed to straight line for tax purposes (Pet. 7–9).[3] This would

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[1] As petitioners note (Pet. 5), a single asset is depreciable to no more and no less than 100 percent of its basis. The result is that the acceleration of depreciation in earlier years is balanced by less than straight-line depreciation of the asset in later years. The overall effect of a depreciation policy depends on the rate of the company's growth, since almost any company will have property of various vintages and the higher depreciation taken in the early years of each vintage tends to offset the lower depreciation of the later years of the older assets. If the plant is expanding savings accumulate and if the plant is stable past savings are preserved. See *Alabama-Tennessee*, *supra*, 359 F. 2d at 336; see, also, Pet. App. 23a–25a. In the 5 years 1961–1965, Class A and B pipelines had accumulated over $450 million in deferred tax reserves (J.A. 416). This represented a contribution of over $900 million by the ratepayers, since the reserve came out of income on which the customers had to pay the tax as well. ("J.A." refers to the Joint Appendix in the court of appeals.)

[2] For tax purposes petitioners used the double-declining-balance method under which they took 7 percent of cost at the end of the first year, and 7 percent of the balance remaining at the end of each following year. For book and rate making purposes they used a straight-line rate of 3.5 percent (see, for example, 32 FPC 993, 1035).

[3] *Alabama-Tennessee* was decided on February 3, 1964. A hearing examiner ruled on April 29, 1964, that "flow through" should be applied to petitioner Midwestern; on May 11, 1964,

have added $546,960 to Midwestern's and $374,312 to East Tennessee's annual cost of service (Pet. 3a–4a).

After full hearings the Commission found (Pet. App. 30a–36a), as had the examiners (J.A. 349–350, 367–371), that the plants of petitioners had been growing and would continue to do so. Midwestern's rate of growth was conservatively[4] estimated at 1.5 percent, and East Tennessee's at 4 percent. The Commission also held that any financial risk in the use of liberalized depreciation was remote, since tax savings would continue so long as the plant grew or remained stable (Pet. App. 24a–25a).[5] And, in the

its Board of Directors voted to change its accounting method, effective as of January 1, 1963 (Pet. App. 10a).

On October 22, 1964, the Commission ordered the investigation of East Tennessee's rates (J.A. 328). In December 1964 East Tennessee voted to change its method, effective with its 1964 tax return.

[4] The Commission found not unreasonable its staff's estimate of a 7 percent growth rate for Midwestern (Pet. App. 33a). Although expressly disregarded here, a year later the Commission approved a substantial expansion of Midwestern's plant. (Pet. App. 31a, 48a; *Great Lakes Gas Transmission Co.*, 37 FPC 1070, pending *sub nom. Northern Natural Gas Co.* v. *Federal* Power Commission, C.A.D.C., No. 21333.)

[5] The Commission rejected (Pet. App. 28a) the suggestion (Pet. 8) that with flow through of liberalized depreciation, Midwestern would require an immediate rate increase of $1 million and subsequent annual increases of $270,000. This claim was based on the assumption, contrary to Midwestern's own testimony (J.A. 30, 61, 104), that there would be no additions to the company's plant after December 31, 1961 (J.A. 284), and on an earlier examiner's decision which the examiner and the Commission rejected here, see Pet. App. 27a–28a, 47a. Midwestern's claimed (Pet. 8) inability to meet its bond-interest-coverage requirements was thought refuted by Midwestern's prior ability to sell its bonds even though, as bond purchasers knew, it had never succeeded in fully meeting these requirements (Pet. App. 29a; J.A. 374–377).

event of contraction, any increase in tax costs due to diminished depreciation in later years would be substantially offset by the reduction in taxes attributable to the reduction in revenues resulting from a shrinking rate base (Pet. App. 28a).[6]

On this record, the Commission held that petitioners' changes to straight-line depreciation—the maximum-tax-cost, maximum-rate method—exceeded "the ambit of managerial discretion". Petitioners' rates were accordingly fixed on the assumption that liberalized depreciation were used and the savings flowed-through to the customers.[7] (Pet. App. 37a, 39a.) The court of appeals affirmed (Pet. App. 85a).

The decision below is plainly correct and there is no conflict of decisions; further review of this case is not warranted.

1. The principle established by *Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F. 2d 518 (C.A. 5), certiorari denied, 385 U.S. 847,

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[6] Petitioners' asserted fear that future plant contraction might result in increased revenue needs at a time when competitive conditions might make higher rates impossible (Pet. App. 25a–28a) was therefore rejected. In addition, the Commission noted that Midwestern had sought to increase its tax costs and rates in 1964, when its competition had significantly lower rates (Pet. App. 12a–13a, 25a).

[7] In the case of East Tennessee, the flow through requirement was made prospective to permit the company to obtain leave from the Internal Revenue Service to conform its tax depreciation practice with the rate treatment ordered (Pet. App. 40a, 75a). Midwestern had stipulated earlier that the Commission's decision on this issue would be effective as of October 13, 1964, and the Commission so ordered (Pet. App. 40a–43a). The Internal Revenue Service authorized petitioners to revert to liberalized depreciation for the 1966 tax year (Pet. App. 75a).

and *City of Chicago* v. *Federal Power Commission*, 385 F. 2d 629 (C.A.D.C.), certiorari denied *sub nom. Public Service Commission of Wisconsin* v. *Federal Power Commission*, 390 U.S. 945, that liberalized depreciation results in a tax saving for companies with expanding plants, is not seriously contested here. Nor is the proposition that the Commission may require the flow through of savings resulting from use of liberalized depreciation. The only issue is whether petitioners' rates were properly based on the assumption that such savings could be achieved.

The choice of depreciation method for rate purposes is not, as petitioners contend, committed to management. A public utility must avoid extravagant or unnecessary costs,[8] and must give its customers the benefit of economies of operations and tax savings.[9]

No less is required by the aim of the Gas Act—"to protect consumers against exploitation at the hands of natural gas companies." *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 610; *Federal Power Commission* v. *Tennessee Gas Transmission Company*, 371 U.S. 145, 154; *Atlantic*

[8] *Acker* v. *United States*, 298 U.S. 426, 430–431; *Safe Harbor Water Power Corp.* v. *Federal Power Commission*, 179 F. 2d 179, 199–201 (C.A. 3), certiorari denied, 339 U.S. 957; see *South Carolina Generating Co.* v. *Federal Power Commission*, 249 F. 2d 755, 765 (C.A. 4).

[9] *El Paso Natural Gas Co.* v. *Federal Power Commission*, 281 F. 2d 567, 573 (C.A. 5), certiorari denied *sub nom. State of California* v. *Federal Power Commission*, 366 U.S. 912; *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 316 F. 2d 659, 663 (C.A.D.C.), certiorari denied, 375 U.S. 881; *Cities of Lexington, Ky.* v. *Federal Power Commission*, 295 F. 2d 109, 116–117 (C.A. 4).

Refining Company v. *Public Service Commission of New York (Catco)*, 360 U.S. 378, 388. The protection of the consumer from unnecessary charges frequently involves the overriding of managerial judgments, and the Commission has the duty to reject unfounded, expensive management decisions.

Nothing in *Southwestern Bell Telephone Co.* v. *Public Service Commission of Missouri*, 262 U.S. 276, 289, and *West Ohio Gas Co.* v. *Public Utilities Commission of Ohio*, 294 U.S. 63 (see Pet. 11–12), stands for a contrary proposition. As Mr. Justice Cardozo, speaking for the Court in *West Ohio*, made clear (294 U.S. at 68), "A public utility will not be permitted to include negligent or wasteful losses among its operating charges." The defect in those cases was (*id.* at 72) "the absence of a showing of inefficiency or improvidence" in past management decisions to incur various costs. Here, in contrast, the record plainly supports the Commission conclusion (Pet. App. 39a) "that the actions of Midwestern and East Tennessee do, in fact, exceed the ambit of managerial discretion" in planning to incur future costs and add them to future rates.[10]

The dispositive point is whether petitioners' future growth would be such that liberalized depreciation

[10] Petitioners notably demand an absolute right to use the approach that would impose on ratepayers an even higher cost than the former normalization accounting. Under both normalization and use of straight line depreciation for all purposes, the tax cost is the same for rate making. Normalization, however, because it carries a lesser tax liability, permits the accumulation of reserves. The use of reserves as an interest free sum available for investment results in a lesser charge on ratepayers than petitioners' proferred method.

would in the long run result in tax savings. Petitioners' complaint goes to the Commission's choice among conflicting forecasts of growth rates (Pet. 13–16; 19–20). Petitioners' evidence showed, however, that there would be growth and not contraction.[11] And it is the fact of growth, not the rate, that means liberalized depreciation will result in a tax saving. *Alabama-Tennessee, supra,* 359 F. 2d at 336.[12]

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[11] As to *Midwestern*, see J.A. 30, 61, 104; and *East Tennessee*, see J.S. 12–13, see also 349.

[12] There is no inconsistency between the Commission action here and in *United Gas Pipe Line Co.*, 31 FPC 1180, and *Wisconsin Michigan Power Co.*, 31 FPC 1445 (see Pet. 17–18). In those cases, as the Commission noted here, there was no showing "that mandatory use of liberalized depreciation methods would result in a net tax saving * * *." Those two companies, moreover, had always used straight line depreciation for tax purposes (Pet. App. 23a–24a).

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